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**OFFICE OF THE LEGISLATIVE AUDITOR**  
STATE OF MINNESOTA

Financial Audit Division Report

**Statewide Report on Internal Control  
Over Financial Reporting  
Fiscal Year Ended June 30, 2006**



March 22, 2007

07-04

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## Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota state government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately forty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of representatives and senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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If you have comments about our work, or you want to suggest an audit, investigation, or evaluation, please contact us at 651-296-4708 or by e-mail at [auditor@state.mn.us](mailto:auditor@state.mn.us)

# Statewide Report on Internal Control Over Financial Reporting

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### Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Cecile M. Ferkul, CPA, CISA	Deputy Legislative Auditor
James Riebe, CPA	Audit Manager
Laura Peterson, CPA	Auditor-in-Charge
Carl Otto, CPA, CISA	Auditor
Thom Derus	Auditor
Tracy Gebhard	Auditor
Steven Johnson, CPA, CISA	Auditor
David Westlund	Auditor
Zachary Yzermans	Auditor
Mark Kliegle	Intern
Mike Hassing, CPA, CISA	Audit Manager (Human Services)
Dave Poliseno CPA, CISA, CFE	Audit Manager (Revenue)
Brad White CPA, CISA, CFE	Audit Manager (Employment and Economic Development)

### Exit Conference

We discussed the results of the audit with representatives from the following state agencies at an exit conference on March 9, 2007:

Department of Finance:

Tom Hanson	Commissioner
Stephanie Andrews	Deputy Commissioner
Lori Mo	Assistant Commissioner
Barb Ruckheim	Financial Reporting Director
Jeanine Kuwik	Financial Reporting Supervisor
Everett Hageman	General Ledger Supervisor

(over)

## Statewide Report on Internal Control Over Financial Reporting

Department of Employment and Economic Development:

John Stavros

Chief Financial Officer

Department of Human Services:

David Ehrhardt

Internal Audit Director

Department of Transportation:

Alan Weiszel

Accounting Systems Director

Mary Ann Fraszak

Director of Financial Operations

Dennis Herzog

Financial Reporting Supervisor

# Statewide Report on Internal Control Over Financial Reporting

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## Report Summary

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### Key Conclusions:

The state's financial statements for fiscal year 2006 were fairly stated in all material respects. However, the state had some weaknesses in internal control over financial reporting as noted below.

### Findings:

- The Department of Finance (Finance) did not sufficiently mitigate the risk of potential misstatements in the state's financial statements caused by the lack of complete information in the state's accounting system, the state's decentralized accounting environment, and personnel turnover in financial reporting positions. ([Finding 1, page 5](#))
- Finance did not accurately account for certain balances in the preliminary financial statements. ([Findings 2 and 3, pages 7 and 8](#))
- The capital asset balances determined by the departments of Transportation and Finance required \$29 million in audit adjustments. ([Finding 5, page 9](#))
- Several state agencies provided incomplete or inaccurate information to the Finance for financial reporting, including Natural Resources ([Finding 4, page 9](#)); Revenue ([Finding 6, page 10](#)); Employment and Economic Development ([Finding 7, page 11](#)); and Human Services ([Findings 8 and 9, pages 11 and 12](#)).

The audit report contained nine findings relating to internal control weaknesses.
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### Audit Scope:

We audited the state's financial statements for the year ended June 30, 2006. Our audit encompassed work at many of the larger state agencies that managed financial activities that were significant to the state's financial statements.

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### Background:

Finance is responsible for preparing the state's annual financial statements. Each year the financial statements are included in the Comprehensive Annual Financial Report published by the department.

In developing this report, we applied criteria included in the recently issued Statement on Auditing Standards #112, Communicating Internal Control Related Matters Identified in an Audit, for assessing the sufficiency of internal controls over financial reporting. As a result, the issues included in this report relate to internal controls in the state's financial reporting process as a whole and not just to those that exist at Finance.

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**OFFICE OF THE LEGISLATIVE AUDITOR**  
State of Minnesota • James Nobles, Legislative Auditor

Representative Rick Hansen, Chair  
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Tom Hanson, Commissioner  
Department of Finance

In auditing the State of Minnesota's basic financial statements for the year ended June 30, 2006, we considered the state's internal controls over financial reporting and tested the state's compliance with significant legal provisions. This report contains our findings and recommendations. However, given the limited nature of our audit work, we do not express an overall opinion on the effectiveness of the State of Minnesota's internal controls or compliance. In addition, our work may not have identified all significant control deficiencies or instances of noncompliance with legal requirements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we communicate significant internal control deficiencies and noncompliance to management and those charged with governance. In developing this report, we applied the criteria included in the recently issued Statement of Auditing Standards #112, *Communicating Internal Control Related Matters Identified in an Audit*, for assessing the sufficiency of internal controls over financial reporting. As a result, the issues included in this report relate to internal controls in the state's financial reporting process as a whole and not just to those that exist at the Department of Finance. We consider the internal control deficiencies described in Findings 1 through 9 in the accompanying section, entitled *Current Findings and Recommendations*, to be significant in the aggregate. According to auditing standards, a control deficiency is significant if there is more than a remote likelihood that a consequential misstatement to the financial statements could occur and not be prevented or detected by the state's internal control.

Individual agency responses to our findings and recommendations are presented in the accompanying section of this report titled, *Agencies Responses*. We did not audit the responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the State of Minnesota's management and the Legislative Audit Commission and is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit the distribution of this report, which was released as a public document on March 22, 2007.

/s/ James R. Nobles

James R. Nobles  
Legislative Auditor

/s/ Cecile M. Ferkul

Cecile M. Ferkul, CPA, CISA  
Deputy Legislative Auditor

End of Fieldwork: December 14, 2006

Report Signed On: March 19, 2007

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# Statewide Report on Internal Control Over Financial Reporting

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## Current Findings and Recommendations

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### 1. The Department of Finance (Finance) did not sufficiently mitigate the risk of potential misstatements in the state's financial statements.

Although Finance improved its financial reporting process over the past year, the fiscal year 2006 preliminary financial statements submitted for audit still required significant adjustments. Last year we proposed numerous adjustments resulting in significant changes to the state's preliminary financial statements.<sup>1</sup> In response, Finance made several improvements to the financial reporting process, including completing independent quality control reviews of preliminary financial statements, reconciling interfund transactions, and verifying financial information contained in footnote disclosures before providing the information to our office for audit. It also worked with the Department of Transportation to resolve some specific financial reporting problems with accounting for local government reimbursements of construction costs. However, the preliminary financial statements still required significant adjustments this year.

Table 1 summarizes the current year audit adjustments we proposed and Finance made. In addition to the adjustments presented in Table 1, the department's preliminary budgetary financial statements contained significant errors. We highlight some of the adjustments in more detail in subsequent findings.

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**Table 1**  
**Audit Adjustments (in thousands)**  
**Fiscal Year 2006**

<u>Opinion Unit Impacted</u>	<u>Increases to Fund Balance/Net Assets</u>	<u>Decreases to Fund Balance/Net Assets</u>	<u>Reclassifications</u>
General Fund	\$52,499	\$44,804	\$58,051
Federal Fund	-	-	16,704
Aggregate Remaining Fund Information	16,002	-	44,448
Unemployment Insurance Fund	14,425	-	11,033
Governmentwide Governmental Activities	36,175	10,086	64,848
Component Units	-	-	43,437

Source: Auditor prepared.

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<sup>1</sup> See Legislative Audit Report 06-11.

## Statewide Report on Internal Control Over Financial Reporting

The audit adjustments resulted from the following weaknesses in the state's internal controls:

- the state's primary accounting system cannot generate accurate financial statements without significant manual accounting entries;
- state agencies continue to need guidance and oversight to provide accurate and reliable information for financial reporting in a decentralized environment; and
- human resources management considerations, including staffing levels, qualifications, and compensation, need to be addressed within the department.

We believe the lack of certain mitigating controls to address these weaknesses in the aggregate results in a significant deficiency<sup>2</sup> in the state's internal control over financial reporting. Despite the control weaknesses, which we discuss in the following sections, Finance successfully issued the state's financial statements by year-end due to the efforts of its conscientious and dedicated financial reporting staff.

### The State's Primary Accounting System

The state's primary accounting system, basically a cash basis accounting system, cannot produce either financial statements that conform to generally accepted accounting principles or financial statements prepared on the budgetary basis of accounting without significant manual accounting entries. The Governmental Accounting Standards Board requires that governments prepare both of these types of financial statements, each with unique accounting requirements.

To prepare financial statements in accordance with generally accepted accounting principles, Finance must make many manual adjustments. The fund level financial statements and the government-wide financial statements also require the application of different accounting principles. Since the accounting system was not designed for these types of complex financial reporting, Finance needs to rely on another software application (Fundware) to manually adjust the accounting system data and create the financial reports. This introduces even more complexity into the financial reporting process. Similarly, since the accounting system cannot generate the budgetary financial statements, Finance has devised a complex set of database queries that require further analysis and interpretation to prepare the budgetary statements. The reliance on a significant amount of manual adjustments and the use of additional accounting applications to compile the financial statements increases the risk of errors.

### Decentralized Organizational Structure

The Department of Finance relies on other state agencies, such as Transportation, Human Services, Revenue, and Education, to provide much of the information needed for the manual adjustments to prepare financial statements in accordance with generally accepted accounting principles. In this decentralized environment, Finance needs to ensure that those agencies can provide accurate information for financial reporting. Findings 3 through 9 give examples of deficiencies in communicating accurate and timely financial information between state agencies and Finance.

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<sup>2</sup> According to auditing standards, a control deficiency is significant if there is more than a remote likelihood that a *consequential* misstatement would not be prevented or detected. A control deficiency elevates to a material weakness if there is more than a remote likelihood that a *material* misstatement would not be detected. None of the issues in this report are material weaknesses.

# Statewide Report on Internal Control Over Financial Reporting

## Human Resources Management

Another challenge for Finance has been hiring, retaining, and developing staff in its financial reporting unit. In last year's report, we suggested that Finance may not have committed sufficient resources, in terms of the numbers of employees and appropriate job classifications, to the preparation of accurate financial statements. This year, Finance continued to experience significant personnel turnover in the financial reporting unit and in other positions that support the financial reporting function. For example, a different department employee has been responsible for financial reporting for capital assets each of the past three years. Employee turnover has resulted in less experienced staff preparing financial statements, huge work load demands, and additional supervisory demands on more experienced personnel, each of which increases the risk of misstatements. Staffing concerns could be related to job classifications and compensation levels given the significant responsibilities staff have for statewide financial reporting. In recent months, Finance has contacted Employee Relations for assistance in considering these staffing concerns.

### *Recommendations*

- *Finance needs to improve the state's controls over financial reporting by incorporating additional reconciliations, analytical reviews, procedures for determining financial statement amounts, and training for staff that will aid in the timely detection of significant errors.*
- *Finance should continue to work with its human resources division and the Department of Employee Relations to determine if the staffing levels, job classifications, and compensation structures are consistent with the statewide financial reporting responsibilities of its staff.*

## **2. The Department of Finance's preliminary budgetary financial statements contained significant errors.**

The draft budgetary statements contained errors in the original budget, final budget, and actual amounts for expenditures. Most of the errors pertained to the General Fund. The preliminary statements for the General Fund expenditures included errors in the original budget of \$17.8 million, the final budget of \$183.1 million, and actual expenditures of \$10.9 million. Similar errors existed, to a lesser degree, in non-General Fund budgetary statements. The budgetary statements compared both the original and final budget figures to the actual revenues and expenditures.

The majority of the errors resulted from Finance incorrectly accounting for transfers made between funds and state agencies. For example, the General Fund final budget amounts were overstated by \$106 million for transfers within the fund, and \$77.1 million for transfers from other funds. The state's accounting system cannot prepare budgetary statements; therefore, Finance must make significant and complex manual adjustments to the accounting system that increase the risk of errors.

## Statewide Report on Internal Control Over Financial Reporting

Finance also experienced staff turnover in the position that would have been responsible for preparing the budgetary financial statements. Finance was unable to fill the vacant position. As a result, supervisors who normally would have provided the high-level direction and review of the preparation of the draft statements were instead responsible to prepare the financial statements.

### *Recommendation*

- *Finance should determine if it can develop a better approach for preparing the budgetary financial statements. If Finance retains the current process, at a minimum it needs to ensure that sufficient staff resources are committed to preparing the statements and that there is a well-defined process to adjust the accounting system, including adjustments for transfers, to prepare accurate budgetary statements.*

### **3. Finance made some mistakes in accounting for financial information supplied by other state departments.**

Finance incorrectly recorded the following transactions in the draft financial statements. In these cases, the information had been accurately reported by other state agencies. Finance understated accrued interest payable of \$22.8 million related to corporate income tax refunds from the Hutchinson Technology Supreme Court ruling. The information had been supplied by the Department of Revenue.

The Department of Human Services bills noncustodial parents for child support payments and receives reimbursements for the federal and state share of the program costs, as well as the recovery of federal administrative fees. Human Services recorded these receipt transactions in the state's accounting system as reductions to expenditures instead of as revenue. However, accounting principles<sup>3</sup> require that the reimbursements be recognized as revenues in financial statements. Finance correctly reclassified the state share as revenue in the General Fund. However, it did not correctly account for the federal share, which resulted in an audit adjustment of \$16.7 million.

Finally, Finance did not record \$10.7 million of school aid payables in the state's General Fund that had been reported by the Department of Education.

### *Recommendation*

- *When Finance relies on other agencies for information included in the financial statements, it should:*
  - *ensure the accuracy of the resulting manual adjusting entries; and*
  - *consider providing a copy of the adjusting entry for verification by the department that provided the information.*

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<sup>3</sup> GASB Statement No. 33, paragraph 26.

## Statewide Report on Internal Control Over Financial Reporting

### **4. The departments of Natural Resources and Finance did not accurately account for all land purchased by Natural Resources in fiscal year 2006.**

Finance coordinates with other state agencies to ensure that the state's capital assets, including land, are accurately reported on the state's financial statements. Due to miscommunication and delayed follow-up between Finance and Natural Resources, Finance attempted to independently summarize Natural Resources' land purchases recorded in the state's accounting system. However, Finance failed to identify \$11.8 million in land purchases because of an error in the query; the query limited purchases to those coded to budget fiscal year 2006 and did not include purchases that were coded to prior budget fiscal years. The correct amount of Natural Resources fiscal year 2006 land purchases totaled \$23.7 million. In total, land purchases in the state's financial statements for governmental activities amounted to \$122.2 million in fiscal year 2006.

An effective internal control system over financial reporting ensures that pertinent accounting information is identified and communicated in a form and time frame that promotes the preparation of accurate financial statements.

#### *Recommendation*

- *The Department of Natural Resources needs to provide Finance with the information necessary to accurately present its land purchases in the state's financial statements. Ideally, the information submitted will include a reconciliation to the land purchases recorded in the accounting system.*

### **5. The departments of Transportation and Finance did not properly account for fiscal year 2006 additions to the infrastructure and right of way capital asset balances.**

The draft financial statements required a total of \$29 million in audit adjustments to the infrastructure and right of way capital asset balances. Finance and Transportation shared responsibility for determining the capital asset balances this year. After adjustments, infrastructure and right of way capital asset additions for fiscal year 2006 amounted to \$451.9 million and \$98.5 million, respectively. The fiscal year 2006 audit adjustments resulted from a combination of problems, such as not including costs of certain projects, overstating amounts reimbursed by local governments, and including costs from prior years. The amount of this year's audit adjustments were smaller than in prior years; however, numerous audit adjustments have been required for several years to ensure the accuracy of the capital asset balances included in the state's financial statements.

Many factors contribute to the complexity of calculating the infrastructure and right of way balances. However, a strong system of internal control includes accounting procedures that anticipate the financial reporting consequences of these complex accounting transactions and that can adapt to new ways of financing construction projects.

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## *Recommendation*

- *Transportation and Finance should work together to ensure the accuracy of capital asset amounts in the state's financial statements.*

### **6. The Department of Revenue did not accurately calculate certain tax-related amounts for inclusion in the state's financial statements.**

The Department of Revenue did not always provide accurate financial information to Finance for inclusion in the state's financial statements. Those misstatements, which resulted in significant audit adjustments, included the following:

- Revenue overstated the amount of its estimated sales tax refunds payable reported to the Department of Finance by \$47.6 million. The adjusted sales tax refunds payable amounted to \$212.7 million. The reported amount included an estimated payable for sales tax refund claims not yet filed with the department, plus an amount for claims on hand on June 30, 2006, that had not been refunded to taxpayers. However, the estimated payable already included the unpaid sales tax refund claims on hand at the end of the year. Therefore, the unpaid sales tax refund claims were double-counted in the payable amount submitted to Finance.
- Revenue overestimated its allowance for doubtful accounts for state property taxes receivable. In 2001, the department began collecting a state property tax from owners of commercial/industrial and seasonal/recreational properties. Since then, the department has estimated its allowance for doubtful accounts for state property taxes at 10 percent. However, the actual uncollectible amount was only about 1.5 percent. This resulted in the department understating the June 30, 2006, state property taxes receivable amount by \$27.6 million. The adjusted property taxes receivable amount totaled \$321.1 million at June 30, 2006.
- Revenue understated the amount of accrued fuel tax revenues reported to Finance by \$11.9 million. The department's calculation included a reallocation adjustment that reduced the accrued revenue by \$11.9 million. However, the reallocation adjustment was already properly recorded in the state's accounting system as a fiscal year 2006 accrual. Thus, the reallocation adjustment was double-counted in the draft financial statements.

## *Recommendation*

- *Revenue should ensure that it accurately reports the additional information needed by the Department of Finance for the state's financial statements by:*
  - *taking into account the financial activity recorded in the accounting system when determining additional accrual adjustments; and*
  - *strengthening controls over estimated amounts, including periodically reviewing the department's actual experience with uncollectible property taxes and adjusting its estimated allowance for uncollectible accounts if necessary.*

## Statewide Report on Internal Control Over Financial Reporting

### **7. The Department of Employment and Economic Development (DEED) overstated liabilities in the preliminary Unemployment Insurance Fund's financial statements.**

The financial statements DEED submitted to Finance for the Unemployment Insurance Fund overstated the liability for unearned revenue by \$14.4 million. The liability represented unearned employer insurance premiums collected in the current year that were deferred and applied against subsequent tax obligations. In fiscal year 2006, DEED began using a new unemployment insurance accounting system and mistakenly included unearned revenue amounts from both the former system and the new system in calculating the unearned revenue liability.

DEED and Finance had comparative financial statements available that contained both current year and prior year account balances; however, neither department investigated the substantial increase in the unearned revenue liability this year. The Unemployment Insurance Fund had \$6.3 million in unearned revenue on June 30, 2005, yet it reported \$24 million as of June 30, 2006. Although insurance premiums also increased over the prior year, the sharp rise in the dollar amount of the unearned revenue liability should have prompted additional scrutiny and review that would have detected the error. Our audit adjustment reduced the June 30, 2006, liability down to \$9.6 million to reflect the amount measured by the new tax system. Without the audit adjustment, the unemployment insurance liability reported in the state's annual financial statements would have been significantly misstated.

#### *Recommendation*

- *The departments of Employment and Economic Development and Finance should investigate and determine the propriety of material fluctuations in the Unemployment Insurance Fund's financial statement balances between fiscal years.*

### **8. The process used by the Department of Human Services to calculate estimated liabilities for health care programs contained errors.**

Human Services understated the amount of the fiscal year 2006 claims liability for services provided to clients before July 1, 2006, that had not been submitted or paid by the state as of August 2006. The errors resulted in an audit adjustment of \$8.6 million. Medical assistance payables in the General Fund and Federal Fund totaled \$702.1 million after adjustment. According to government accounting principles,<sup>4</sup> a claim that is probable and can be reasonably estimated needs to be included in the financial statements.

The spreadsheet used by the department to estimate the claims liability contained several mathematical errors. The allocation percentages used for calculating the Medical Assistance payable estimate totaled 106.8 percent when they should have totaled 100 percent. To get the

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<sup>4</sup> Governmental Accounting Standards Board Statement 10, paragraph 22.

## Statewide Report on Internal Control Over Financial Reporting

allocation to reconcile to the total estimate amount, the department overwrote the spreadsheet formula for the General Fund with a manually entered amount.

The department also did not compare its past estimated claim amounts to the actual claims subsequently filed. The department overstated its fiscal years 2004 and 2005 estimates for the Special Revenue Fund's Medical Assistance Program by more than \$10 million each year. Similarly, it overstated its fiscal years 2004 and 2005 estimates for the total Health Care Program by more than \$24.5 million and \$43.7 million, respectively. If the department had performed a comparison of estimated claims to actual amounts paid, these discrepancies should have caused them to reexamine the reasonableness of the estimation formulas.

Auditing standards<sup>5</sup> state that an entity's internal controls may reduce the likelihood of material misstatements of accounting estimates if the controls include two key elements: a comparison of prior accounting estimates with actual results to assess the reliability of the process used to develop the estimates, and adequate review and approval of the accounting estimates by the appropriate levels of authority. The department's design of internal controls over its claim estimate calculations did not include these specific procedures. Therefore, the risk of misstatements increases when relying on manual calculations of accounting estimates.

### *Recommendations*

- *Human Services should ensure the accuracy of the underlying data and related calculations used to produce the estimate of unsubmitted claims payable.*
- *Human Services should conduct an adequate review of the calculation that compares prior estimates of the claims liability to actual results to determine if adjustments to future estimates are necessary.*

### **9. The Department of Human Services did not properly design internal controls over financial reporting in two areas.**

Human Services did not design certain key controls over financial reporting in two areas: the allocation of medical payments to the proper funding sources, and the accounts receivable verification process. As described below, the control deficiencies resulted in only minor audit adjustments to agency-prepared financial statement amounts this year, but the potential for larger misstatements exists under the current structure.

Human Services' internal control procedures did not provide reasonable assurance that it allocated medical payments to the correct funding source. In March 2006, the Medicaid Management Information System payments for the state share of some transactions did not process properly in the state's accounting system because the account did not have enough funds to cover the transactions. Department accountants changed the funding account to pay the state share of administrative fees out of the federal account in error. The correct allocation

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<sup>5</sup> Statement on Auditing Standards No. 57, "Auditing Accounting Estimates."



## Statewide Report on Internal Control Over Financial Reporting

for these payments should have been 50 percent federal and 50 percent state. These allocation errors occurred in nine Medicaid payment runs between March 2006 and June 2006, resulting in \$600,000 being paid from the Federal Fund instead of from the General Fund. (The department subsequently adjusted its financial data and reimbursed the Federal Fund.)

Although this was not a large error in a multi-billion dollar program, it identified a weakness in the department's internal controls. The department's existing process to reconcile the Medicaid payment system to the posting of transactions on the state's accounting system reconciled the total payment amount but did not reconcile the amounts posted to individual funds.

In addition, the department's controls for determining the correct amount of its accounts receivable accrual did not detect an error, which resulted in an understatement of claims receivable. While the amount of the error was immaterial, the potential for a financial statement error to be more than inconsequential exists under the current control process.

The department did not detect errors in the accounts receivable report for the federal Temporary Assistance to Needy Families Program. The department prepares its Annual Accounts Receivable Report by summarizing data from its subsystem about overpayment collection activity. The program supervisors review the summary level information to determine whether they need to investigate any significant variances or discrepancies. However, this review process does not include a verification that the summary information agrees to the underlying detail. Without this verification, the potential for significant variances occurring and not being detected or reviewed increases.

### *Recommendation*

- *Human Services should improve key controls to prevent or detect financial reporting misstatements by:*
  - *developing an effective reconciliation process between Medicaid subsystem payments and amounts posted to the state's accounting system that would discover fund allocation errors in a timely manner; and*
  - *establishing a more comprehensive review process over the accumulation of accounts receivable information to ensure that errors are detected and corrected in a timely manner.*

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# Statewide Report on Internal Control Over Financial Reporting

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## Status of Prior Audit Issues As of December 14, 2006

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**March 16, 2006, Legislative Audit Report 06-11** examined Finance's activities and programs material to the State of Minnesota's Comprehensive Annual Financial Report and the Single Audit for the year ended June 30, 2005. Our audit work focused primarily on Finance's preparation of the state's financial statements and its centralized responsibilities related to cash, debt management, and payroll, including the calculation of compensated absences liabilities. The Single Audit scope covered compliance with federal requirements relating to cash management and statewide indirect costs.

The report contained three findings. First, Finance submitted preliminary financial statements for audit that required significant adjustments. Although Finance made progress in its financial reporting process, the fiscal year 2006 preliminary financial statements still contained significant errors. See Finding 1 of this report for additional details. Second, the departments of Transportation and Finance did not properly account for reimbursements of construction costs received from the local units of government. The departments resolved this specific finding; however, we found other large errors in the infrastructure and right of way capital asset amounts this year. See Finding 5 of this report. Finally, Finance gave several employees incompatible access to the state's accounting system. Finance resolved this finding.

### State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as the metropolitan agencies, or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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March 15, 2007

James R. Nobles, Legislative Auditor  
Office of the Legislative Auditor  
658 Cedar Street  
140 Centennial Office Building  
St. Paul, MN 55155-4708

Dear Mr. Nobles:

Thank you for the opportunity to discuss your audit findings for the Statewide Report on Internal Controls Over Financial Reporting. We gained a better understanding of the new auditing standard (SAS No. 112), and the related changes in reporting thresholds and terminology. It was also helpful to understand that your conclusions were based on the aggregate and not individual findings. Since this year's report includes all findings statewide, our response will address only those findings related to the Department of Finance; the remainder of the findings will be addressed by the specific agency involved.

We place a high priority on continuing our long history of issuing high quality, accurate financial statements. Our 21-year history of receiving unqualified audit opinions and the "Certificate of Achievement for Excellence in Financial Reporting" from the Government Finance Officers Association is important to us. We value suggestions which will make our existing process even stronger.

### **Recommendation**

Finding 1. Finance needs to improve the state's controls over financial reporting by incorporating additional reconciliations, analytical reviews, procedures for determining financial statement amounts, and training for staff that will aid in timely detection of significant errors. Finance should continue to work with its human resources division and the Department of Employee Relations to determine if the staffing levels, job classifications, and compensation structures are consistent with the statewide financial reporting responsibilities of its staff.

### **Response**

As you indicate, the preparation of the state's financial statements and budgetary financial statements are very complex processes. The state's accounting systems operates on a modified cash basis of accounting and requires thousands of entries to prepare financial statements in accordance with Generally Accepted Accounting Principles (GAAP) and the Legal Level of Budgetary Control. These are inherent risks over financial reporting that are similar to most states and large local governments.

To mitigate these risks, we prepared extensive analysis, reconciliations, and adjustments. Due to the complexity of the state's operation and programs, we will continue to rely on agencies' expertise of their programs. We work closely with agencies through both meetings and formal correspondence to ensure that they understand the required information needed to make the appropriate adjustments. In addition, the Financial Reporting Unit will continue to monitor and interpret new GAAP pronouncements and work with state agencies to obtain additional adjustments necessary to prepare financial statements in accordance with GAAP.

We have experienced turnover in several key positions in financial reporting. In addition to the demographic factor of "baby boom" retirements that are impacting the entire workforce, the market is experiencing high demand for accounting and auditing professionals. This is due in part to the increased financial reporting scrutiny in the private sector. In addition, the complexity of these highly skilled jobs, and unique skill set required, has contributed to both recruitment and retention issues. We have and will continue to pursue these issues with the Department of Employee Relations.

As a result of this turnover, we had three vacant positions and several recent hires for the preparation of this year's financial statements. We have highly skilled and dedicated staff on our financial reporting team. As a result of the vacancies, they took on additional work and even recent hires performed complex assignments. Supervisors provided recent hires with extensive training on both governmental accounting and our financial statement preparation process. But the vacancies also required supervisory and management staff to be involved in more detailed preparation of the financial statements, which led to limited capacity to perform independent reviews. We are in the process of filling our vacancies and we continue to work on training and development. This includes cross training complex areas of the financial statements and training for the budgetary financial statement preparation. To further mitigate the risk of potential misstatements, we will expand our independent supervisory review on the financial statements. Additional actions to resolve this finding are discussed in subsequent items and agency responses.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: December 31, 2007

### **Recommendation**

Finding 2. Finance should determine if it can develop a better approach for preparing the budgetary financial statements. If Finance retains the current process, at a minimum it needs to ensure that sufficient staff resources are committed to preparing the statements and that there is a well-defined process to adjust the accounting system, including adjustments for transfers, to prepare accurate budgetary statements.

### **Response**

Due to vacant positions within the unit, the supervisor prepared the budgetary financial statements in addition to the supervisor's other responsibilities. This did not leave sufficient resources to perform an independent review of the budgetary financial statements.

The position responsible for preparing the budgetary financial statements has been filled and training is in process. We are currently analyzing and documenting the budgetary financial statement process.

The impact of adjustments to total expenditures for the final budget was \$29 million. This represents an overstatement of \$106 million offset by an understatement of \$77 million. This was primarily a result of a single query being missed, which would have eliminated certain transfers from the final budget. Total expenditures for the General Fund were \$15.5 billion. The adjustment to actual expenditures resulted from moving a \$5.4 million program between two lines with no impact to the total actual expenditures.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: November 30, 2007

### **Recommendation**

Finding 3. When Finance relies on information submitted by other agencies for inclusion in the financial statements it should ensure the accuracy of the resulting manual adjusting entries and consider providing a copy of the adjusting entry for verification by the department that provided the information.

### **Response**

As discussed in finding 1, the state's accounting system requires more than 2,000 journal entries to prepare the financial statements in accordance with GAAP. We are responsible for preparing financial information for 63 funds and 10 component units along with the Government-wide financial statements and corresponding notes.

While reviewing the funds, the auditors identified some mistakes, three of which are cited in finding 3. The first item relates to an unusual adjustment as a result of a change in estimate that is very unique to the current year. The second item relates to a reclassification of \$16.7 million between Health and Human Services function, which totaled \$4.2 billion and Federal Revenue of \$5.4 billion. The third item relates to a discrepancy between the amounts the agency reported to us as paid during the close period vs. what they reported in the state's accounting system.

We will continue to work with agencies to ensure amounts are reported accurately and adjustments are entered correctly. Fund accountants will continue to review documentation in the prior year fund file to ensure all entries are made and documentation from agencies is reasonable. As part of this process, fund accountants perform an analytical review analysis and investigate and document significant variances. All documentation will be updated based on new GAAP pronouncements or changes to programs requiring adjustments from past practice. We will expand our ledger activity analysis to additional funds to ensure the financial statements are not materially misstated.

We have considered obtaining agency verification of the adjusting entries. However, due to the volume of journal entries, we believe it is not practical to obtain concurrence from agencies submitting information.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: November 30, 2007

**Recommendation**

Finding 4. The Department of Natural Resources needs to provide Finance with the information necessary to accurately present its land purchases in the state's financial statements. Ideally, the information submitted will include a reconciliation to the land purchases recorded in the accounting system.

**Response**

We are working with the Department of Natural Resources to develop a process to ensure we receive the necessary capital asset information on a timely basis for inclusion in the state's financial statements.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: October 31, 2007

**Recommendation**

Finding 5. Transportation and Finance should work together to ensure the accuracy of capital asset amounts in the state's financial statements.

**Response**

The calculation of the Department of Transportation's Infrastructure and nondepreciable capital assets is very complex and represents approximately \$7.3 billion in capital assets on the state's financial statements. We will continue to work with Transportation to ensure the amounts reported for capital assets are accurate. We recognize this will be an on-going effort to discuss changes within the programs and impacts on the financial statements.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: October 31, 2007

**Recommendation**

Finding 7. The departments of Employment and Economic Development and Finance should investigate and determine the propriety of material fluctuations in the Unemployment Insurance Fund's financial statement balances between fiscal years.



**Response**

Analytical review procedures are performed on each fund included in the state's financial statements. Significant variances are investigated. The analytical review procedures performed on the Unemployment Insurance Fund's financial statements focused on significant variances in revenues, interfund activity and transfers from the prior year. We will continue to perform analytical procedures and investigate significant variances. We are also working with the Department of Employment and Economic Development to address the level of detail necessary to accurately capture accounts receivable information from their new system.

Person Responsible: Barb Ruckheim, Financial Reporting Director

Implementation Date: October 31, 2007

Sincerely,

*/s/ Tom J. Hanson*

Tom J. Hanson  
Commissioner

## Statewide Report on Internal Control Over Financial Reporting

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## Minnesota Department of Natural Resources

500 Lafayette Road  
St. Paul, Minnesota 55155-4010

March 12, 2007

Barbara Ruckheim  
400 Centennial Building  
658 Cedar Street  
St. Paul, MN 55155

Dear Ms. Ruckheim,

Thank you for the opportunity to respond to the findings of the Statewide Report on Internal Control Over Financial Reporting for the year ending June 30, 2006.

**Audit Finding 4: The departments of Natural Resources and Finance did not accurately account for all land purchased by Natural Resources in fiscal year 2006.**

*Audit Recommendation: The Department of Natural Resources needs to provide Finance with the information necessary to accurately present its land purchases in the state's financial statement. Ideally, the information submitted will include a reconciliation to the land purchases recorded in the accounting system.*

Audit Response: With clear communication and follow-up from the Department of Finance, the Department of Natural Resources will continue to cooperate with the Department of Finance in providing them with the necessary information that is required to accurately present land purchases for the state's financial statements. A single point of contact for all Department of Natural Resources financial statement transactions will be provided to Finance.

Again, thank you for the opportunity to respond to the audit finding and recommendation.

Sincerely,

*/s/ Denise Anderson*

Denise Anderson  
Chief Financial Officer

c: Mark Holsten, Commissioner  
Laurie Martinson, Deputy Commissioner

## Statewide Report on Internal Control Over Financial Reporting

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March 12, 2007

James R. Nobles  
Legislative Auditor  
100 Centennial Office Building  
658 Cedar Street  
St. Paul, Minnesota

Dear Mr. Nobles:

Thank you and your staff for taking the time to review the summary audit report. My staff and I appreciate your effort and are committed to satisfactory resolution of the findings. Following is Mn/DOT's response for Finding 5.

**Finding 5 – The departments of Transportation and Finance (DOF) did not properly account for fiscal year 2006 additions to the infrastructure and right-of-way capital asset balances.**

*Auditor's Recommendation: Transportation and Finance should work together to ensure the accuracy of capital asset amounts in the state's financial statements.*

Response: Mn/DOT and DOF are committed to satisfactory resolution of this finding. Following are the actions that both agencies will be taking:

- 1) Staff from Mn/DOT's Office of Finance will work cooperatively with appropriate staff from Department of Finance to document the processes of gathering data and reporting information regarding Highway Infrastructure and Right-of-Way.
- 2) Mn/DOT's Office of Finance will take responsibility for identifying the correct information necessary for calculating the Highway Infrastructure and Right-of-Way financial statements.
- 3) Department of Finance will review the calculations in item 2 to ensure accuracy of the financial statements.
- 4) Appropriate staff from Mn/DOT and DOF will meet at least annually to discuss unique funding methods that could affect financial reporting.

Responsible Persons: Kevin Z. Gray, Mn/DOT, Finance and Administration Division Director

Implementation Date: April 2007

Thank you for the opportunity to respond to your Finding and Recommendation. We will be working cooperatively with the Department of Finance. Please contact Terry Lemke at 651-366-4876 for follow-up information and activity.

Sincerely,

*/s/ Carol Molnau*

Carol Molnau  
Lieutenant Governor/Commission of Transportation

# MINNESOTA • REVENUE

March 14, 2007

James R. Nobles  
Legislative Auditor  
Office of the Legislative Auditor  
658 Cedar Street  
140 Centennial Office Building  
St. Paul, Minnesota 55155-1603

Dear Mr. Nobles:

This is in response to the Office of Legislative Auditor's (OLA) recommendations in connection with its annual audit of the Department of Revenue's financial reporting. This audit was undertaken as part of the OLA's effort to verify the accuracy of the State's financial statements.

This year's audit report combines all financial statement issues into one management letter. Here is the Department's response to the recommendations pertaining to its reporting of financial information to the Department of Finance.

## **6. The Department of Revenue did not accurately calculate certain tax-related amounts for inclusion in the State's financial statements.**

The Department of Revenue provided inaccurate financial information to the Department Finance which was included in the State's financial statements. That information, which resulted in audit adjustments, included the following:

- The Department overstated the amount of sales tax refunds payable by \$47.6 million. The adjusted sales tax refunds payable amounted to \$212.7 million. The amount reported included an estimate of sales tax refund claims not yet filed, plus an amount for claims on hand on June 30, 2006 that had not been refunded to taxpayers. However, the estimate of sales tax claims not yet filed was already included in the amount of unpaid sales tax refund claims on hand at the end of the year. Therefore, the estimate of sales tax refund claims not yet filed was mistakenly reported twice.
- The Department overstated the allowance for doubtful accounts for property taxes receivable. In 2001, the Department began collecting state property tax from the owners of commercial/industrial and seasonal/recreational properties. Since then, the Department has estimated an allowance of 10 percent for doubtful accounts for state property taxes due. However, the actual amount of uncollectible property taxes is about 1.5 percent. This resulted in the Department understating the June 30, 2006, state property taxes receivable by \$27.6 million. The adjusted property taxes receivable amount totaled \$321.1 million on June 30, 2006.
- The Department understated the amount of accrued fuel tax revenues by \$11.9 million. The Department's calculation included a reallocation adjustment that reduced the accrued revenue by \$11.9 million. However, the reallocation adjustment had already been properly recorded in the State's accounting system as a fiscal year 2006 accrual. Thus, the reallocation adjustment was made twice.

*Recommendation*

- *Revenue should ensure that it accurately reports the additional information needed by the Department of Finance for the State's financial statements by:*
  - *taking into account the financial activity recorded in the accounting system when determining additional accrual adjustments; and*
  - *strengthening controls over estimated amounts, including periodically reviewing the Department's actual experience with uncollectible property taxes and adjusting its estimated allowance for uncollectible accounts if necessary.*

**Response:** The Department of Revenue is committed to accurately reporting information to the Department of Finance for the State's financial statements. To strengthen controls over estimated amounts, the Department will meet with the Department of Finance prior to the fiscal year financial reporting cycle to review and analyze procedures. The Department will also review adjustments made during the accrual period to verify the accuracy of the amount recorded. In addition, the Department will monitor uncollectible property taxes to ensure the accuracy of its allowance for uncollectible accounts. Jean Jochim will take responsibility for adding these steps to the Department's year end procedures.

On behalf of the Department, I wish to thank you and your staff for the helpful recommendations and assistance provided to our agency.

Sincerely,

*/s/ Dennis Erno*

Dennis Erno  
Assistant Commissioner





March 12, 2007

Mr. Tom Hanson  
Commissioner, Department of Finance  
Fourth Floor, Centennial Office Building  
658 Cedar Street  
St Paul, MN 55155

Dear Mr. Hanson:

The following information is offered in response to the draft audit report on the statewide financial statement audit for the fiscal year ended June 30, 2006.

Auditor's Finding 7. The Department of Employment and Economic Development (DEED) overstated liabilities in the preliminary Unemployment Insurance Fund's financial statements.

Auditor's Recommendations:

- The departments of Employment and Economic Development and Finance should investigate and determine the propriety of material fluctuations in the Unemployment Insurance Funds' financial statement balances between fiscal years.

**Response:**

**We agree. We will work with the Department of Finance to investigate and determine the propriety of material fluctuations in financial statements between fiscal years.**

**Responsible Person: John Stavros 651-229-7085 or e-mail [john.stavros@state.mn.us](mailto:john.stavros@state.mn.us)**

Sincerely,

A handwritten signature in black ink that reads "Dan McElroy".

Dan McElroy  
Commissioner

## Statewide Report on Internal Control Over Financial Reporting

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March 13, 2007

James R. Nobles, Legislative Auditor  
Office of the Legislative Auditor  
Centennial Office Building  
658 Cedar Street  
St. Paul, MN 55155

Dear Mr. Nobles:

The enclosed material is the Department of Human Services response to the findings and recommendations included in the draft audit report of the Department of Finance's financial and compliance audit conducted by your office for the year ended June 30, 2006. It is our understanding that our response will be published in the Office of the Legislative Auditor's final audit report.

The Department of Human Services policy is to follow up on all audit findings to evaluate the progress being made to resolve them. Progress is monitored until full resolution has occurred. If you have any further questions, please contact David Ehrhardt, Internal Audit Director, at (651) 431-3619.

Yours sincerely,

*/s/ Cal R. Ludeman*

Cal R. Ludeman  
Commissioner

Enclosure

**Department of Human Services  
Response to the Department of Finance Audit Report  
For the Year Ended June 30, 2006**

Audit Finding #8

The process used by the Department of Human Services to calculate estimated liabilities for health care programs contained errors.

Audit Recommendation #8

- *Human Services should ensure the accuracy of the underlying data and related calculations used to produce the estimate of unsubmitted claims payable.*
- *Human Services should conduct an adequate review of the calculation that compares prior estimates of the claims liability to actual results to determine if adjustments to future estimates are necessary.*

**Department Response #8**

The department agrees with the recommendations. Accordingly, the department will implement the following internal control measures:

- The methodology for estimates will be evaluated annually by management, including a comparison of prior estimates to actual results.
- The spreadsheet used to calculate the estimates will be tested annually to ensure all formulas are accurate.
- Annual estimates will be reviewed by management prior to submission to the Department of Finance.

**Person Responsible:** Martin Cammack

**Estimated Completion Date:** June 30, 2007

Audit Finding #9

The Department of Human Services did not properly design internal controls over financial reporting in two areas.

**Department of Human Services  
Response to the Department of Finance Audit Report  
For the Year Ended June 30, 2006**

Audit Recommendation #9

*Human Services should improve key controls to prevent or detect financial reporting misstatements by:*

- *Developing an effective reconciliation process between Medicaid subsystem payments and amounts posted to the state's accounting system that would discover fund allocation errors in a timely manner; and*
- *Establishing a more comprehensive review process over the accumulation of accounts receivable information to ensure that errors are detected and corrected in a timely manner.*

**Department Response #9**

The department agrees with the recommendations. Accordingly, the department will implement the following internal control measures:

- Procedures for reconciling the Medicaid payment system to the posting of transactions on the state's accounting system will be modified to ensure the amounts posted are accurate -- both in total, and fund by fund.
- Manually prepared summary reports used in the preparation of the Annual Accounts Receivable Report will be "spot checked" for accuracy against source documentation.

**Person Responsible:** Martin Cammack

**Estimated Completion Date:** June 30, 2007